



P.O. Box 2749
Sacramento, CA 95812-2749
Telecommunications Device for the Deaf - (916) 795-3240
(916) 795-3400

June 19, 2006

AGENDA ITEM 6b

TO: MEMBERS OF THE INVESTMENT COMMITTEE

- I. SUBJECT:** Executive Compensation Strategic Plan Update
Macro Economic Initiatives
- II. PROGRAM:** Global Equity
- III. RECOMMENDATION:** Information Only
- IV. ANALYSIS:**

Executive Summary

This agenda item is the third update of CalPERS' progress to implement executive compensation reform as it pertains to the following macro economic strategies of CalPERS' three-year Executive Compensation Strategic Plan:

- 1. SEC engagement
- 2. SRO/Exchange engagement
- 3. Compensation consulting industry engagement

This agenda item updates the Committee on each of the three strategies. A separate update is provided to the Committee on the micro economic strategies.

Background

Compensation programs are one of the most powerful tools available to align the interests of executive managers with those of shareowners. Since shareowners have a strong interest in long-term performance, CalPERS believes the marketplace should move to a pay-for-performance based model. In recognition

of this, on November 15, 2004, CalPERS' Investment Committee approved a three-year Corporate Governance Executive Compensation Strategic Plan (Attachment 1) in order to raise the level of accountability of public company boards and compensation committees to shareowners.

Staff has committed to providing periodic updates to the Investment Committee on the progress of CalPERS' efforts to implement executive compensation reform as it pertains to the following macro and micro economic strategies:

Macro Economic Strategies:

1. SEC engagement
2. SRO/Exchange engagement
3. Compensation consulting Industry engagement

Micro Economic Strategies:

1. Promoting reform at the largest companies
2. Enhancing compensation committee accountability
3. Recognizing pay-for-performance leaders

The previous update to the Investment Committee is included in this Agenda Item as Attachment 2.

Staff continues to implement CalPERS' Executive Compensation Strategic Plan with the intention of providing periodic updates to the Investment Committee. This is the third update on staff's progress since inception of the three-year strategic plan.

Executive Compensation Strategies Update

3 Macro Economic Strategies

1) SEC engagement – The Committee approved the following objectives:

- Develop and submit to the SEC a comprehensive proposal for increased disclosure related to executive compensation in 2005.
- Coordinate broad institutional investor collaboration to support SEC rule making for increased executive compensation disclosure.

On January 27, 2006, the SEC released its proposed rule for Executive Compensation and Related Party Disclosure. CalPERS submitted a comment letter endorsing the SEC's proposal in addition to providing additional recommendations for consideration (Attachment 3). Additional recommendations include:

- Disclose specific performance metrics used to support the payment of incentive compensation to executives.
- Option values should be included in Supplemental Tables to allow investors to differentiate between the values of equity grants that are time based versus performance based.
- Disclose dividend equivalents in the Other Compensation column versus the proposed Non-Stock Incentive column of the Summary Compensation Table.
- Disclose the vesting schedule versus the proposed expiration date in the All Other Equity Awards Table.
- Adopt rules to increase the use of the clawback provision at corporations.

At its meeting following release of the SEC's final rule for Executive Compensation and Related Party Disclosure, staff will provide an update on the final rule to the Investment Committee.

2) SRO/Exchange engagement – The Committee has approved the following objectives:

- Engage national SROs/Exchanges to seek support in the development of executive compensation disclosure requirements.
- Advocate the enhancement of exchange listing standards that incorporate compensation philosophy and practice to better align boards and management of listed companies with shareowners.

Staff has met with the current leadership at the NYSE to encourage the involvement of the Exchange in improving transparency in executive compensation of listed companies. While there was broad philosophical agreement that much improvement is needed, the Exchange was noncommittal in incorporating any formal policies into exchange listing standards. Staff will continue to seek opportunities that support the development of executive compensation disclosure requirements.

3) Compensation consulting industry engagement – The Committee has approved the following objectives:

- Take a leadership position in coordinating institutional investor support to develop a focused approach of engaging and communicating investors' compensation program preferences to the compensation consulting industry.
- Educate the compensation consulting industry with a better understanding of shareowner preferences for how companies utilize

executive compensation to better align boards and management with shareowners.

- Affect compensation consulting practices to address executive compensation reform by engaging major compensation consulting firms.

In May 2006, staff engaged the executive compensation consulting industry on the subject of employee stock option backdating, which is causing dozens of companies to come under investigation by the Securities and Exchange Commission. Valuable input provided by the executive compensation consulting industry, internal research conducted by staff and guidance from the Corporate Governance Internal Staff Working Group has lead to the development of a staff engagement initiative targeting global equity portfolio holdings that are being investigated by the SEC for alleged employee stock option backdating.

Actions by the Investment Committee and Staff

On February 14, 2006, the Investment Committee directed staff to amend CalPERS' Corporate Governance Core Principles and Guidelines to provide for the development and disclosure of "clawback" provisions in order to recoup merit-based compensation awarded on the basis of misstated or fraudulent company performance.

Staff addressed this direction at the March 13, 2006 Investment Committee meeting by receiving Investment Committee approval to revise CalPERS' Corporate Governance Core Principles and Guidelines to include the following principle:

- **Incentive and bonus compensation:** Companies should develop and disclose a policy for recapturing bonus and incentive payments that were made to executives on the basis of having met or exceeded performance targets during a period of fraudulent activity or a material negative restatement of financial results for which executives are found personally responsible.

The Investment Committee directed staff to formally review Representative Barney Frank's "Protection Against Executive Compensation Abuse Act." Both Global Equity and Government Affairs staff worked together in analyzing House Resolution (HR) 4291 (Barney Frank, (D-MA)) "The Protection Against Executive Compensation Abuse Act (Attachment 4) to determine the consistency of the bill with CalPERS' principles for executive compensation. In keeping with the conclusion reached by Global Equity and Government Affairs staff, the Board of Administration accepted a support recommendation presented by the

Government Affairs Office in Agenda Item 15-A, House Resolution (HR) 4291 (Barney Frank, (D-MA)) "The Protection Against Executive Compensation Abuse Act (Attachment 5).

On March 29, 2006 at the CalPERS 2006 Federal Workshop in Washington, DC, members of the Investment Committee and staff met with Congressman Barney Frank (D-MA) to discuss House Resolution (HR) 4291 (Barney Frank, (D-MA)) "The Protection Against Executive Compensation Abuse Act and to express CalPERS' support position for the bill.

On May 25, 2006, Christy Wood, Senior Investment Officer Global Equity, represented CalPERS' support position for House Resolution (HR) 4291 (Barney Frank, (D-MA)) "The Protection Against Executive Compensation Abuse Act by testifying before the U.S. House Financial Services Committee (Attachments 6). Written testimony was also submitted to the U.S. House Financial Services Committee (Attachment 7) in support of the bill.

New Initiative

Company Engagement-Clawback Provision

An engagement initiative to get the largest U.S. companies to adopt a clawback provision for their compensation plans has been developed and implemented. The revision to CalPERS' Corporate Governance Guidelines and Principles to incorporate a clawback principle, supports this engagement initiative.

Companies targeted for engagement to adopt a clawback provision were determined by identifying the five largest U.S. companies in each of the ten economic sectors of the U.S. equity market (Attachment 8). Under this approach, the actual number of companies for engagement is less than fifty because through additional research, staff identified companies that already have a clawback provision in place. Companies that did not have a clawback provision in place received an initial engagement letter requesting them to adopt a clawback provision (Attachment 9). Staff will report its progress with this initiative in the next update to the Investment Committee.

Summary

Over the course of the past 19 months, staff has met with the New York Stock Exchange, the Security and Exchange Commission, numerous investor groups, the largest executive compensation consulting firms and members of the U.S. Congress in order to effect change in pay-for-performance standards as well as disclosure and transparency for shareowners. These efforts are all ongoing. An

update of the three micro economic strategies will be provided to the Investment Committee in a separate agenda item.

IV. STRATEGIC PLAN:

This item is consistent with the Strategic Plan: Goal I, exercise global leadership to ensure the sustainability of CalPERS' pension and health benefit systems.

V. RESULTS/COSTS:

Staff anticipates that existing resources are sufficient to support this effort.

Dennis A. Johnson
Senior Portfolio Manager
Corporate Governance

Christianna Wood
Senior Investment Officer
Global Equity

Russell Read
Chief Investment Officer